

## Investment View March 2011

The situations in the Middle East and Japan have dominated world attention over recent days and weeks. These events are likely to take some of the shine off global growth, but unlikely to derail it completely, but to lead to further upward pressure on commodity prices, including oil and gas. However, we are still a long way from being tipped into global recession. The current situation only reinforces the view that inflation risks remain a dominant concern.

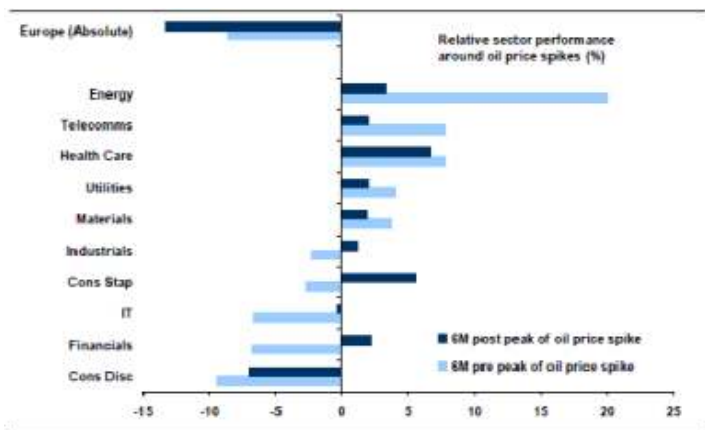
The earthquake measuring 9.0 on the Richter scale took place at sea to the east of Japan. A tsunami sparked by the quake hit the coast of Miyagi and Iwate prefectures, leading to massive loss of life, devastation to property and problems in the area's nuclear reactors. The human impact of those affected and bereaved cannot be imagined. As the emergency begins to ease, fund managers and economist are trying to assess how it will affect the markets and the country's wider economy.

Economic activity is bound to decline in the short term, but with the progress in relief work and the recovery in infrastructure, the economy should return to a recovery track. The central bank has injected 15 trillion yen to provide liquidity and stability to financial markets. Based on the information currently available, Schroders and many other fund managers on the ground do not believe there has been serious overall damage to the business sustainability of many Japanese companies. We believe there has been substantial over-selling and over reaction and Japan is an area worthy of close examination by investors. It is rarely reported that Japan has several power stations that have been mothballed and are already being commissioned to provide the lost output from the damaged nuclear reactors. However, it should be remembered that Japan is a major buyer of US Treasury Stock and it may be that we see Japanese investors reducing this commitment to support infrastructure and re-building projects in the devastated prefectures. There was an immediate rush to Treasury stock as markets reacted sharply downwards on the news from Japan. We have not been strong supporters of Government stock over the last year or so, preferring corporate or high yield bonds to Government securities and that remains the view. Our bias continues to be towards high yield bonds as particularly investment grade corporate bonds may have been overbought at the moment.

Prompted by political turmoil in MENA (Middle East and North Africa) countries, oil prices have surged, outperforming other commodity prices and asset classes. If oil prices move higher still, and stay high, the risks to the global economy are well known – higher headline inflation and lower real growth. The traditional rule of thumb is 10% on oil prices means 0.25% off global growth, so with oil up 20% since the start of the year, approximately 0.5% has been knocked off growth expectations. However, we must consider the strength of economies before these events. Looking at recent data, it is clear that the global economy has real momentum, but, there is no doubt that a sustained move higher in oil prices risks imparting a stagflationary shock to the global economy, especially the developed economies. It is also worth noting that historically, a bear market starts two months after the oil price rises 100% year on year. Currently the rate is 50% year on year. The recent United Nations military action in Libya has seen oil prices rise further over the last day or two.

What the higher oil price means for interest rates is unclear. Basically, there are two opposing forces at work. A positive oil price shock should push headline inflation higher, but it also poses material downside risk to economic growth, and hence should lower real interest rates. The US is certainly in the latter camp with seemingly no intention of moving rates anytime soon - there needs to be a significant improvement in employment there first. Europe and the UK are clearly fearful of the inflationary threat, and pressure is growing for an early move.

### Relative sector performance around oil prices: Energy strong, Consumer Cyclicals weak



Source: NSCI, Datastream, Morgan Stanley Research

However, the global growth outlook remains the key driver of stocks. The current rise in oil prices is not enough to derail a global economy where momentum is strong and where monetary policy is accommodative. Nevertheless, the oil price is likely to stay high, even if geopolitical fears subside; given the heightened sense of risk and an increasing focus on the structurally tight supply/demand balance. This could have an impact on margins as we go through the year, but as long as revenue growth continues to surprise positively, then the market can resume its upward progress.

Although we face an extended period of lacklustre economic growth in the UK that does not mean that the equity market can't do well. Having planned for a full-blown depression, companies were generally able to cope very well with what turned out to be 'only' a recession. Having taken difficult cost-cutting decisions at the low point of the cycle, companies are now reaping the benefits and in some cases profit margins will exceed previous peaks. Consequently underlying corporate cashflow is strong and balance sheets are repaired and this combination of robust cashflow and balance sheet strength means that prospects for dividend growth are rosy for the next couple of years, even if it still feels like a recession to the man in the street. Dividends will therefore look very attractive relative to savings rates that look set to remain low for an extended period. We continue to view income funds very positively to help combat price volatility that is prevalent in all markets and to provide some cushion if capital growth stalls.

Long-only fund managers have been quick to take fright at the rising inflation in the emerging markets, but as fast as they tilt their allocations towards the developed world, hedge funds are snapping up their unwanted emerging market stock. There's no doubt some hedge funds have gone short on emerging markets – the high oil price is not good for places like India but this is less so for China and Russia. At a recent JP Morgan presentation the view that emerging markets should continue to drive Global growth for many years was robustly promoted. China's economy was roughly 1/3<sup>rd</sup> of the US economy in 2010, but is predicted to be almost the same size by 2020. For the long term investor emerging markets should have substantial appeal.

We remain positive about European exposure and particularly Germany, which has a strong economy partly due to the inroads its manufacturing base has made in emerging markets. Markets did see some policy measures emerge from the recent EU summit. These are likely to help stabilise the situation in Europe in the short-term, but still leave us well away from a sustainable long-term solution. Europe is a long way from being out of the woods but the major economies, apart from Spain, should not be ignored.

Federal Reserve officials said the US economic recovery was on a "firmer footing", upgrading their outlook on the back of a gradual improvement in the labour market but pledging to press on with monetary stimulus as planned. But a battery of external risks will make Fed officials wary of being too optimistic. Consumer spending and confidence could be hit as Americans feel increasingly squeezed by high energy costs. The data coming out from the US often provides mixed signals but we view US stocks with strong interest and believe the continuing recovery provides opportunity for equities.

We expect the appeal of global property is likely to persist through 2011, and potentially beyond, as it provides several important characteristics currently highly valued by investors. Firstly, the demand for yield is a broad based theme that should remain in place barring a material spike in global interest rates and a major repricing of fixed income securities. Secondly, in most markets, current rental values do not justify the cost of development, and financial institutions have no stomach for funding speculative development. With the risk of excess supply hitting the market several years, property funds provide some inflation protection as even modest economic growth could lead to further upward pressure on rental levels. We hold a positive outlook, but recognise that macro events pose the largest risk to the sector. Capital growth will be fairly modest over the next few years. Income returns of 6.5-7% will be the mainstay of performance. The level of income should prove attractive to investors; provided gilt yields remain below 4-4.5%

Overall we are facing a fairly misty short-term outlook in markets at the moment as we are dealing with the implications of the earthquake in Japan and the continued political events in the Middle East. Looking at underlying market conditions, we expect the global economy to remain robust, although it could slow somewhat as we go into the middle of the year.

**Douglas Kearney C.A. Investment Director**